REMARKS OF RICHARD B. SMITH, COMMISSIONER
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AT THE CENTER FOR RESEARCH IN SECURITY PRICES,
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"Corporate Disclosures to Security Analysts"

It was almost a year ago that I spoke here at the University of Chicago at the Seminar sponsored by the Center for Research in Security Prices. This Center has exercised a role of leadership in working for greater cooperation among economists and lawyers in analyzing the manifold aspects of our nation's securities markets. At my last appearance here, I spoke about some ways in which the much needed cooperation could take place. The title to my talk was "Equity and Efficiency in the Securities Markets," and I used the words "equity" and "efficiency" to refer respectively to the principal considerations of lawyers and economists.

Our topic this afternoon is "Quest for Optimum Rules Regarding Disclosure of Information." I shall deal with one aspect of that subject: corporate disclosures to security analysts. I do so for two reasons: first, because I thought it would be most relevant to you here and, second, because this aspect of the disclosure problem, perhaps more than any other, involves a possible conflict between considerations of equity and considerations of efficiency. I shall attempt to delineate that conflict and then offer some suggestions for dealing with it. In doing so, of course, in accordance with our customary practice, I speak only for myself and not for my colleagues or staff at the Commission.

The Job of the Security Analyst

There are presently some 15,000 security analysts in this country. Of these, approximately 12,000 have satisfied the three-year experience requirement and are members of the Financial Analysts Federation. These security analysts are a highly professional group and, according to the March 1968 survey of its members, 92 per cent of the analysts have at least a bachelor's degree and 48 per cent have at least one higher degree.

I would also like to assure George and others that the Commission is very conscious of the fact that administrative agencies are a composite of functions that must be kept separate. In accordance with the Administrative Procedure Act and with general views of the way administrative agencies should operate, we go to great lengths to keep our judicial, enforcement and legislative (rule-making) functions separate.

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The breakdown of the businesses in which the particular analysts are employed is interesting:* 28 per cent are employed by investment dealers, and 20 per cent by commerical banks. These are the two largest employers of analysts. Looked at another way, investment dealers, counsellors and research firms together and up to 47 per cent of the analysts. The institutional investors--commercial banks, insurance companies, mutual funds, endowment and pension funds, and industrial corporations--had about 44 per cent. Thus, about half of the expert analytic effort is in the institutions and about half in the securities firms. The balance of nine per cent includes academic and miscellaneous categories.

In a commendable effort to upgrade the qualifications of the profession, the Federation administers a series of three examinations and confers the title of Chartered Financial Analyst on those members who pass the examinations. There are about 2,000 CFA's.

You could describe the security analysts's job as composed of three subjects with interrelated phases: the gathering of data; the digestion and interpretation of that data; and finally, the evaluation of the security. Now those analysts who are working as portfolio men may also be making the eventual investment decision. But that is not part of the analytic process as such. I shall focus my remarks this afternoon on the information-collecting phase. That is where conflict between equity and efficiency is most possible.

*Business	Percent
Investment dealers	28
Investment counsellors	12
Investment research firms	7
	47
Commercial banks	20
Insurance companies	12
Mutual funds	6
Endowment/pension funds	2
Industrial corporations	4
	44
Academic/government	3
Other	6
	9

The Practical Problem

It is a practical problem to gather the data. The analyst begins with public sources, generally. In large part, they consist of formal documents required by the Commission: registration statements under the '33 Act for public offerings; registration statements under the '34 Act for listed or widely held OTC securities, proxy statements, information statements, annual reports to shareholders, and the periodic reports that are provided under the Commission's reporting system on an annual, semi-annual and current basis.

Some of these required documents have not been sufficiently accessible in the past to facilitate their maximum use by analysts. The new system that the Commission is using to reproduce documents on file there, I hope, is going some distance toward eliminating that dissemination problem.

In addition to the reports and other public documents required by the Commission, corporations customarily publish a wealth of data about themselves, either voluntarily or in response to formal or informal rules of stock exchanges or the National Association of Securities Dealers. In fact, due to the nature and timing of the reports required under the Commission's periodic reporting system, the most up-to-date information will probably be found in such sources as quarterly reports and corporate press releases, rather than in the Commission's public files. While additional improvements in the periodic reporting system are called for, in no case can the system become an appropriate vehicle for rapid and widespread disclosure.

Of course, the analyst may also turn to secondary sources for corporate information and he usually does. Any good research library will contain copies of the various statistical services and many of the advisory publications as well. The statistical services gather previously published data and put it in convenient form. Their reports do not usually contain unpublished information obtained directly from the corporation. The other advisory services are often useful tools for the analyst to compare his own interpretation of published data, but insofar as they or the statistical services contain or are based upon information not published by the corporation, they raise the very problems we are considering. Many analysts are unwilling to rely completely on

published data. In the first place, the published information about a corporation is often not sufficiently detailed for the analyst's purposes. To some extent this arises because of imperfections in the Commission's disclosure rules. For example, analysts are quite naturally interested in the breakdown of reported sales and earnings figures by product line or by lines of business. If the Commission adopts the proposed revision of the registration forms in this respect and then follows through with the recommendations of the disclosure study recently completed, direct contact between analysts and management to obtain this vital investment information should not be necessary.

In terms of the detail of the data, it is probably not feasible to satisfy the analyst's desire for information through published sources. Publication is expensive for the corporation and it is questionable whether it is appropriate to require all the shareholders to pay for the publication of in-depth information that is sought only by the more sophisticated analyst.

There are also certain types of information that are not susceptible to full disclosure on paper because they cannot be reduced to words or figures. One of the most important considerations for an analyst is an evaluation of the abilities and initiative of management. Although the paper record of past achievement is important in that evaluation, personal contact can also be important. An analyst considers his contact with management persons in the flesh, including an opportunity to see how they handle themselves, as an important part of the information-gathering phase of his work.

Finally, there are some types of information that are theoretically susceptible to public disclosure, but for policy reasons are not required to be disclosed to the public in published form. For example, the Commission does not require corporations to report their future competitive strategy. Nor do we require them to publish their internal projections of sales or earnings or capital expenditure. Indeed, we prohibit their publication in prospectuses. In the absence of any such requirement, corporations are ordinarily unwilling to put such information on the public record. If the information is not of extraordinary significance, however, they might be willing to talk off the record about such subjects to analysts whom they can trust not to quote

them. They might do so either by means of affirmative statements to the analyst on these subjects or by comments on the analysts' own stated guesses or conclusions. This is a delicate area in the relationship between a corporation and a security analyst, and I will come back to this later. Here I am simply trying to describe what the analyst seeks to do.

For various reasons the analyst does not complete the data-gathering phase when he has exhausted the published sources about the corporation, for the reasons I have indicated. He then turns directly to management for the additional information he desires. Sometimes, he does this in group meetings with other analysts or with the press present. At other times, he does it alone, either in person or by telephone. Whether singly or in groups, however, the reality is that analysts are constantly seeking to acquire information.

From economist's point of view, the analyst serves a useful function by thus expanding the market's information input. We certainly rely on the free market system rather than on Government fiat to allocate investment capital among competing commercial users. And the collective investment judgment that emerges from this market system is only as good as the individual judgments of which it is composed. They, in turn, can only be as good as the information on which they are based. Consequently, the more information the analysts can bring to the market, either expressly or through their recommendations, presumably the more efficiently the securities market should operate. Indeed the heartening trend toward greater professionalism in the securities business is due in large part to the growing importance of the analyst. It doesn't seem to me desirable to restrict analysts solely to published sources.

The Legal Problem

It is not enough to say that the security analyst performs an economically useful function that promotes efficiency. Considerations of fairness are also important considerations that promote equity. The Court of Appeals, in the Texas Gulf case, to which George Shinn referred earlier, had this to say:

> "The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks--which market risks include, of course, the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital."

So note it is an equity and fairness concept and not an egalitarian one. In implementing this basic philosophy, the Court did not limit its decision to securities transactions by corporate officials on the basis of material inside information. It also held that the rule is violated by the practice of tipping--that is, passing on material inside information to others for use by them or their "sub-tippees" in effectuating securities transactions without disclosure or in recommending securities transactions on that basis. This prohibition on tipping, like the prohibition on trading itself, continues until the information has been made available to all parties to the pertinent securities transaction.

The legal consideration of equity thus imposes certain restrictions on disclosure that is other than by publication, and it bears some pondering. A securities analyst usually seeks this information about a corporation so that he can pass it on to his employer or clients, either explicitly or through a recommendation for their use in securities transactions. If the corporation provides material inside information to an analyst before it is otherwise available, and the analyst can be expected to pass it on for trading purposes, then the corporation itself may be held to have violated Rule 10b-5 by giving a tip.

Of course, disclosures may be made to analysts for other purposes than use in eventual transactions with the public. The analyst may be serving as an official or unofficial consultant to management, or he may be employed by a prospective purchaser of a corporation's securities in a private placement. I shall not deal with these perfectly proper confidential disclosures to particular

analysts. As long as the analyst isolates the information acquired in such contexts and does not allow it to be used for other purposes, either directly or by way of recommendation, there is no problem of tipping involved. I shall focus only on those disclosures to analysts that are made with the expectation that the information will be passed on or used directly for trading purposes.

Suggestions for Accommodating Both Equity and Efficiency

I have been describing briefly how the analyst functions, the importance of not restricting him to published information, and the legal problems raised by not doing so. I will attempt to offer some observations for our discussion this afternoon on the accommodation of equity and efficiency in this area.

In the first place, whatever the results when all analysts are treated equally, there is not warrant for favoritism in dealing with them. As the president of the New York Stock Exchange has aptly put it, "A caste system for release of corporate information...is not consistent with our disclosure standards." In the Glen Alden case, it was the Commission's belief that the corporation had given highly confidential and material corporate information to certain selected investors and would not have given that information to any responsible shareholders or other investors who requested it. There was simply no warrant for such discrimination.

Of course, I don't mean that the treatment of each analyst must be identical. It would be unrealistic to require that the president of a corporation spend as much time personally with an analyst for a small brokerage house as he would with an analyst associated with a large or major institution contemplating the acquisition of a large block of the corporation's stock. There is no reason why all the trappings and social amenities must be the same. But the information that is available to the two analysts should not differ substantially.

When that kind of favoritism is not present, there doesn't seem to be any reason why management may not speak to analysts either singly or in groups and disclose to them information that was not previously published by the corporation. If the information that is given is not material, there is no problem in such meetings. If it is, then a problem may exist.

With that, we come to the question of materiality. What do I mean by materiality in this context? In Texas Gulf the Court of Appeals stated the test of materiality in two ways: whether the information would be of importance to a reasonable investor, and whether "in reasonable and objective contemplation" its disclosure could be expected to affect the market value of the corporation's securities. Although the precise meaning of the phrase "in reasonable and objective contemplation" is not clear, the Commission has stated that it reads the phrase as designed to exclude insubstantial market variations. Thus, the two key words in applying the "materiality" standard--and I consider the two phrasings in practical effect to be merely different formulations of the same standard--are "important" and "substantial." They must be matters of major significance.

Some persons have asked why we don't simply sit down and write a list of those categories of information that are material and those that are not. The difficulty with such an endeavor is that it may tend to oversimplify a very complex area. For example, in his widely circulated panel interview with the Financial Analysts Federation, our distinguished general counsel, Phil Loomis, indicated a broad range of topics that management could properly discuss with analysts. In its recent guidelines on relations with analysts, the American Society of Corporate Secretaries has provided a similar list. But as both Phil and the Society pointed out, the topics so indicated may be material if they are sufficiently important. A converse caveat would have to be added to any list of topics that usually are material.

The reason for the problems inherent in devising such lists is that materiality depends on a large number of factors that often tend in different directions. The size of the corporation is important. A promising new product may be material for a small or medium size corporation, while the same product would not be material for a corporate giant. The same may be true of small mergers and acquisitions. Corporate trends are also significant. An unaudited profit and loss statement for one quarter that shows no change from the previous quarter has a different meaning for a utility with stable earnings over a long period than for a corporation that has been on a consistent upturn or downturn. Seasonal factors must also be considered. A corporation's existing

product mix is also a significant factor. An oil discovery for a one-product company in some other business may have greater importance than the same discovery by a company that is already in the oil business or that is already diversified. There is a very heavy element of judgment in deciding what is material, but that does not necessarily invalidate materiality as a standard.

I have mentioned only a few of the factors that must be considered in determining materiality: the size of the corporation, the previous corporate trends, seasonal factors, the product mix. That is just a start. And if the information is not definitive, in the sense that it relates to the possibility of a future development that has not yet occurred, both the likelihood of the development and its potential importance to the corporation must be considered. Drilling information indicating the possibility of a billion dollar mine may be material, while information indicating a similar degree of likelihood for a ten million dollar mine might not.

You must realize that I have been indirectly commenting on the feasibility of rules or guidelines on the materiality question. I shall expressly address myself to the general problem of rules or guidelines a little later. In the meantime, let me pass on to the next question--publication.

If the information is material, and it has not been previously published by the corporation, then we must ask whether the analyst is receiving information that is not available to the rest of the investing public. If the information is extraordinary in nature, then it seems to me it must be published before or concurrently with the time it is being given to a single analyst or to a group of analysts. The analyst and his clients are not entitled to any head start over the rest of the public. Of course, I recognize that, in answer to an especially perceptive question, a corporate official may on occasion say something that he did not intend to disclose in this manner. If he promptly arranges for the publication of this information and requests the analyst not to use it until this has been accomplished, I don't think that the corporate official should be censured because of a purely understandable mistake that he properly sets out to correct.

If the information is valuable to an astute analyst but not extraordinary in nature, the situation is somewhat different. Analysts and institutional investors are certainly reasonable investors, and information may be valuable to him that would not be important to the average member of the investing public. The problem of publication that I mentioned earlier is particularly applicable here. For example, the average investor would probably be satisfied with an announcement of a major mineral discovery that generally described the discovery, gave figures of its estimated magnitude, and indicated the nature of the data upon which these conclusions were based. The sophisticated analyst or institutional investor, however, may consider it important to ascertain the underlying data and draw his own conclusions about the discovery. On balance, since the basic discovery has already been announced, I don't believe that a press release is the only permissible way to disclose this underlying information.

Let me phrase this reasoning in legal terms. The test of whether or not material information is still considered "inside" might be stated in terms of availability rather than publication. Of course, publication is one means of making the information available, but there is no reason why it must be the only one when the information is not extraordinary. When the information involved is only further elaboration on developments that have already been publicized in a general (but meaningful) way, I believe that the information is sufficiently available if the corporation would make it available to any responsible person who inquired. Or to put it more generally, "availability" is a flexible concept that should be matched in each case to the nature of the information that is actually involved.

To sum up then, it seems to me that favoritism should be avoided in corporate relations with analysts. Individual and group meetings with analysts are certainly not forbidden; and previously unpublished information of a nonextraordinary character may be given out at such meetings. Information of an extraordinary nature should first be disclosed by publication. Earnings figures, whether extraordinary or not, should be published to all--that only makes sense. But there is nothing in Texas Gulf or in the other cases that would seem to me to prevent security analysts from performing their important economic functions by gathering data to supplement published sources.

The question of further rules and guidelines has been much debated of late. George Shinn clearly posed it this afternoon. In the Texas Gulf case itself the Court of Appeals for the Second Circuit suggested that the Commission promulgate further rules to clarify how soon after a public announcement insiders may trade upon the basis of important information contained in the announcement. Since then, thoughtful persons have lined up on both sides of the question of whether rules or guidelines are really feasible or desirable. Recently, the press gave coverage to my own comment sympathizing with those urging that an effort be made at devising guidelines in the area of inside information.

Too often, it seems to me, we debate abstractly among ourselves whether or not something is feasible or desirable but never get down to trying it. Instead of continuing the debate, or whatever you want to call it, over guidelines, perhaps we should set forth a systematic discussion of this particular segment of the insider information area. We should not delude ourselves that the attempt will necessarily be successful or that it is a simple matter. The trouble with any rule-making process, as anyone who has lived through it must know, is that when you start drafting specific rules, it leaves room for and gives access to doing the very thing you are trying to prevent. That doesn't bely the need to make the effort, but we can't assume that it is a simple chore or one that will necessarily provide any greater degree of certitude than we now have. A well researched, ranging treatment of the subject by the Commission might not end up more informative or much different than many of the guidelines that have already been suggested by private individuals and groups. They would, however, bear an authoritative basis that could give some guidance and assurance to the many persons of integrity who are eager to comply with the law. The Commission, in my opinion, should make every effort to provide guidance where that is possible. I think I have said enough as a basis for discussion and "quest." Thank you.